



Everyone Needs a Savings Buffer

Why Income and Expenditure Statements
Need a Default Savings Category



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Everybody needs a savings buffer: Why income and expenditure statements need a default savings category

Unexpected expenses can affect any one of us

Creditors expect that people in debt pay all of their surplus income toward their debts.

- This means that people in debt repayment arrangements have no savings buffer.
- An unexpected expense, eg a car breaks down, a high electricity bill, can be devastating.
- They may end up in default, access further high cost credit or experience poverty.

Solution: a savings buffer

Allow people in debt repayment arrangements to build a savings buffer.

- This would build financial resilience, encourage a savings habit and allow people to take control of their finances.
- A savings buffer is consistent with all of the messages we give about financial literacy.

Creditors can implement a savings buffer by making this the default setting in income and expenditure statements

We know from behavioural insights that people are more likely to accept a pre-set option, requiring opt out.

- Including a savings option as the default in standard creditor income and expenditure statements does this.
- A reasonable savings buffer would be 10% of a person's income or \$20 per month (where the consumer's income can sustain this).
- Financial institutions could help by setting up separate bank accounts for savings to accrue.

Some other issues to think about

A savings buffer could also be incorporated into initial lending decisions and has implications for responsible lending.

We would like to hear your views. Comments are sought by Friday 12th August 2016.

Send to: info@financialcounsellingaustralia.org.au

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About Us

About Financial Counselling

Financial counsellors assist people in financial difficulty. They provide information, support and advocacy to help them deal with their immediate financial situation and minimise the risk of future financial problems. The majority of financial counsellors work in community organisations, although some are employed by government. Their services are free, confidential and independent.

Financial Counselling Australia

FCA is the peak body for financial counsellors in Australia. FCA's member groups are the eight State and Territory financial counselling associations.

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Purpose of this paper

This paper proposes that a savings category is included in standard income and expenditure statements used by creditors when assessing repayment capacity. This would apply for both new loans and for people experiencing financial hardship, entering into debt repayment arrangements.

The expected result would be that consumers would allocate funds to a savings category, generating a savings pool—this would improve their levels of financial control and resilience, providing a buffer against possible future financial shocks.

Most of the emphasis in the paper is on people negotiating debt repayment arrangements. The principle of including a savings buffer in income and expenditure statements however is equally important when credit is first granted and the paper also discusses this aspect.

We would like your views

We would like to hear from creditors, financial counsellors, external dispute resolution schemes, consumers and their representatives about their views on this proposal. Specific questions are incorporated into the paper, but please also let us know your broader thoughts or suggestions. You can ring, email or write to us.

Comments are sought by **Friday 12th August 2016**. FCA will then summarise the views of stakeholders and issue a final report.

Chapter 1. Current situation in Australia and the UK

1.1 Australia

Helping someone deal with their debts often starts with a review of their income and expenditure. This can be requested by a creditor and may be recorded on the Standard Statement of Financial Position, agreed between FCA and the Australian Bankers' Association in 2013. This information is then generally used by the consumer or their representative, such as a financial counsellor, to identify and negotiate affordable repayment arrangements with the creditor(s).

At present, the Standard Statement of Financial Position and most other income and expenditure forms used by creditors don't include a line item for savings, reflecting an expectation that after identifying a baseline level of income required by the debtor, any remaining income will be available to pay towards debts.

1.2 UK Experience

The UK's Money Advice Service (MAS) is the government agency in the UK responsible for promoting financial literacy. MAS also has an oversight and grant-making role in relation to the provision of debt advice (what we know as financial counselling in Australia).

MAS is currently piloting a savings category in its common Standard Financial Statement, which is used by creditors and the debt advice industry. The proposed savings category would allow debtors to allocate up to 10% or £10 of their monthly income as savings, before identifying amounts for living expenses and repayments towards debts. This proposal was welcomed by industry, the debt advice sector and consumer representatives. The new UK Standard Financial Statement, incorporating a savings category, is expected to be launched later this year.¹

¹ Money Advice Service (2015), The Standard Financial Statement: Emerging Themes from Responses to the Consultation, https://masjumprrdstorage.blob.core.windows.net/cms-production/mas_sfs_response1.pdf

Chapter 2. Why a savings category makes sense

2.1 Without a Savings Buffer, Consumers Struggle with Unexpected Expenses

As the saying goes, 'bad things happen to good people'. All of us are at risk of experiencing a sudden financial shock. We might get sick, lose a job or a relationship might break down. In the experience of financial counsellors, and also supported by feedback from the banking sector, these three external events are the cause of financial hardship for many people.

There are also more day-to-day financial issues that often arise in people's lives: a car breaks down and needs repair, a utility bill is much higher than expected or we need to travel at short notice and at great expense to attend a funeral — there are endless scenarios. While in some ways we know these types of events will sometimes occur, many Australians don't plan for them and don't have a savings buffer to fall back on to get them through.

To illustrate, when asked how they would cover an unexpected large expense, around one-quarter of Australian adults surveyed by ASIC said they would use a credit card, store card or overdraft.² Similarly, the ABS General Social Survey found that 13% of the population would be unable to raise \$2,000 within a week for something important and 19% of the population had at least one cash flow problem in the last 12 months (such as being unable to pay an electricity, gas or telephone bill on time).³

2.2 Builds Resilience (and May Reduce Reliance on Predatory Lending)

As described above, we know that all consumers face unexpected costs throughout their lives, and that a savings buffer helps to manage these without recourse to credit or other financial support. Having a savings buffer is a key element in building financial resilience within households, and in enabling consumers to take control of their finances. Without this buffer, consumers are at higher risk of financial stress and hardship.

For those consumers who are in debt repayment arrangements, a savings buffer can be especially beneficial. These consumers face unexpected costs like anyone else, but their options when trying to meet these may be limited to high-cost credit, or dealing with the consequences of not meeting those costs. These outcomes present a real risk of the consumer returning to a financially precarious situation even as they are taking steps to manage and repay previous debt, perpetuating vulnerability, financial stress and poverty.⁴

2 ASIC Rep 464, (2015) *Australian Financial Attitudes and Behaviour Tracker*

3 ABS, 4159.0 General Social Survey: Summary Results, Australia 2014 (released 29/6/2015)

4 Stepchange Debt Charity (2016), *The credit safety net: How unsustainable credit can lead to problem debt and what can be done about it*, http://www.stepchange.org/Portals/0/documents/Reports/StepChange_Debt_Charity_credit_safety_net_report.pdf

Supporting consumers in repayment arrangements to put aside a small proportion of their income each month would allow them to build a savings buffer, shielding them from the impact of unexpected costs and the financial risks these can present. It would provide protection for the consumer against recourse to predatory lending, and could thereby bolster debt repayment arrangements by protecting income from further erosion.

2.3 Encourages a Savings Habit

It isn't easy for consumers without a savings history to become regular savers, and consumers with problem debt may find it especially difficult to save when under pressure to clear their debts. But the value to consumers of having a savings buffer means that learning to put aside even small amounts on a regular basis is worth supporting in a structural way.

Behavioural insight research tells us that consumers are often affected by “present bias”—where they make decisions and take actions based on their current circumstances and perceived immediate rewards, rather than looking to the future impact of their decisions. Consumers affected by present bias will downgrade the value of a reward they perceive as being a long way off (“hyperbolic discounting”).

This can act against making longer-term commitments and can be observed in some consumers' attitudes towards savings, where they can tend to disproportionately value spending money in the short-term, rather than putting it aside for a rainy day or longer-term goal. This particularly applies towards repaying debt. Recent research from the UK indicates that those with little or no savings will often identify paying-down debt as a higher priority, even where their debt levels are the same as a consumer with more than £500 in savings.⁵

While this behaviour is understandable, it shows that consumers with debt can find it hard to accept that they should be putting a little aside for a ‘rainy day’ even as they are paying down debt. Being in a repayment arrangement or facing demands from creditors will reinforce this perception, even though it makes the consumer more likely to resort to credit again if an unexpected cost arises.

This indicates that consumers in debt repayment arrangements may be unlikely (and indeed, unable) to put aside some of their income for savings without structural support to do so. The ANZ Saver Plus program also demonstrates the importance of providing a supportive framework to encourage the development of successful savings habits. This program provides advice and support for savers making small, regular contributions towards a particular goal and matches their savings up to \$500. A key element in the success of this program is the provision of support and encouragement to help participants develop and maintain good savings habits.⁶

2.4 Consistent with the National Financial Literacy Strategy and Research

ANZ's most recent survey of financial literacy measured the levels of financial literacy in the population.⁷ Groups with lower levels of financial literacy include people on low incomes or those with less than \$2,000 in savings and investments. Encouraging a

5 Money Advice Service/Illuminas (2015) *Savings Propensity Research*

6 R Russell, M Stewart and F Cull, (2015) *Saver Plus: A Decade of Impact*

7 ANZ (2011) *ANZ Survey of Adult Financial Literacy in Australia* www.anz.com/about-us/corporate-responsibility/cr-library/

savings habit is therefore likely to have flow-on effects in increasing financial literacy. The key impacts would be increased confidence in dealing with personal finances and consequentially, greater confidence in dealing with financial products – thereby improving levels of financial inclusion and engagement. This is also a finding of the evaluation of ANZ's saver plus initiative and a consistent theme in much of the MAS research and strategy in the UK.

We also note that Australia's 'National Financial Literacy Strategy'⁸ is actively supported by the Australian Bankers Association, individual banks and a number of other financial services industry peak bodies.⁹ These organisations could be expected to be strong supporters of positive financial literacy measures that encourage saving.

Behavioural insight research also reinforces the beneficial impact of creating good financial habits, such as regular saving. Once a consumer has set up the regular savings arrangement, research tells us that this leads to the formation of good savings habits which can continue long after the arrangement has ended.¹⁰

In this way, adding a savings category to income and expenditure statements has the potential to promote positive behaviour change towards achieving financial control among consumers who might previously have characterised their finances as being in 'chaos' or 'out of control'. Fostering good savings habits can therefore work to break the cycle of reliance on credit that traps many consumers. Having the support, encouragement and means to save will enable consumers to develop new skills and strategies to manage their finances and plan for the future. So building a good savings habit not only engenders resilience, as discussed above, but is intrinsically empowering, builds financial capability and literacy and can lead to more positive engagement with financial services more generally.¹¹

2.5 Creditors will Benefit

Creditors can also be expected to benefit from the inclusion of a savings buffer as a standard item when assessing capacity to repay. Over the term of any repayment arrangement it is very likely that the majority of consumers will face some unexpected expenses. A savings buffer, if sufficient time has elapsed, could give consumers something to fall back on. In the absence of any savings, consumers may meet unexpected expenses by defaulting on debt repayments, in order to free up income.

8 Australian Securities and Investments Commission, (2014) *National Financial Literacy Strategy*, http://www.financialliteracy.gov.au/media/546585/report-403_national-financial-literacy-strategy-2014-17.pdf

9 See <http://www.financialliteracy.gov.au/supporters/business-and-industry>, accessed 8th May 2016.

10 Money Advice Service/Illuminas; R Russell et al, op cit.

11 Stepchange Debt Charity (2015), *Becoming a nation of savers: Keeping families out of debt by helping them prepare for a rainy day*

Chapter 3. Our proposal for consumers in financial difficulty

3.1 Overview of the Model

The model below describes how a savings buffer **would work for consumers in financial difficulty** negotiating debt repayment arrangements.

- In considering the capacity of a consumer experiencing financial difficulty to repay their existing debts, a savings buffer is included as a standard line item on all income and expenditure statements (including the standard Statement of Financial Position agreed between the Australian Bankers Association and FCA).
- That the recommended level of the savings buffer is 10% of a consumer's income or \$20 per month (where the consumer's income can sustain the minimum amount of \$20 per month).
- That electronic income and expenditure statements automatically pre-populate the figure for the savings buffer, so it becomes the default option (or if the statement is completed manually, this is the level recommended in any explanatory notes).
- That participation by consumers in setting aside funds for a savings buffer is voluntary. Consumers however would be required to consciously opt out from including some figure for this category in income and expenditure statements.
- That where consumers elect to set aside a savings buffer, that financial institutions facilitate this by helping consumers set up arrangements for savings to accrue in a separate bank account.
- If a savings buffer is introduced, that the initiative is evaluated in say 18 months time and the results published.

3.2 Encouraging Take Up—Applying the EAST Principles

If we accept that a savings buffer is a sensible concept, it follows that we need to think about the best ways for encouraging its take up. The design we are suggesting in the sections following is based on key principles from behavioural insights using the EAST principles.¹² These are:

- **Easy:** Harness the power of defaults as consumers are more likely to go along with a pre-set option—this would be achieved through the inclusion of the savings category as a standard line item, and further strengthened if pre-filled for the consumer.
- **Attractive:** A standard line item offers consumers the option of improving financial resilience at no immediate cost—in that the consumer is not foregoing income which would otherwise be available to him or her as if not put towards savings, would have been diverted to creditors.
- **Social:** Including the savings category on a standardised form creates a powerful norm that putting money aside while still repaying creditors is usual behaviour among consumers in similar situations.

¹² The Behavioural Insights Team, UK Cabinet Office (2014), EAST: *Four simple ways to apply behavioural insights*

- **Timely:** The savings category is presented at a point of disruption in a consumer's life, when they are evaluating their financial situation and making long-term commitments. Consumers are considered to be especially receptive to behavioural prompts at these moments.

? *Are there other changes or other elements that would support take-up of a savings buffer option amongst target consumers?*

3.3 Level of the Savings Buffer

The UK savings category appears likely to be set at 10% of the debtor's income or £10 per month where the consumer's income can sustain this. We propose that the Australian category be similarly 10% of the consumer's income or \$20 per month.

We also propose that there be flexibility in how this is implemented. It will clearly need to take account of individual circumstances to avoid perverse outcomes (such as risk of eviction for non-payment of rent). As indicated above, we consider that participation should also be voluntary, to respect consumers' preferences and take account of their circumstances.

Moreover, it's not intended that the consumer should have to identify a purpose for the savings as the intention is for him or her to accumulate a 'rainy day fund', to protect against unexpected costs, rather than to save for a particular goal.

While we expect that the level of contributions will be low, and accumulation of funds will be slow, it may be that successful savers could generate meaningful balances. For these consumers, it may be more beneficial to re-direct funds towards paying off debts more quickly, once an appropriate buffer has been accumulated. It may also be beneficial to set a monthly ceiling for contributions for the small number of consumers who may have a larger monthly surplus.

? *Is 10% or \$20 a reasonable amount?*

? *Should there be a limit to the amount that consumers repaying debts can save?*

? *Should there be controls on when and how the consumer can withdraw funds from the savings account and on how they can be spent? If so, who should oversee these controls?*

? *Should a savings target be set and once reached, should funds be redirected towards paying off debt? If so, what should the target be?*

? *Should there be a ceiling for monthly contributions?*

3.4 Pre-filling the Statement of Financial Position—A Savings Buffer Default

We propose using a ‘behavioural nudge’—a setting which encourages a particular type of behaviour, taking account of behavioural biases by pre-filling income and expenditure statements with a default amount. This will create a commitment device that the consumer would then need to negotiate down or opt out from. Behavioural research indicates this can be especially powerful in instigating and reinforcing positive behaviour.¹³

By incorporating a savings category into income and expenditure statements as a default setting, the design of these forms will encourage consumers to start saving. This design would be straightforward to implement where an income and expenditure statement was completed online. Where a form was completed manually, accompanying notes would explain the recommended default amount. Financial counsellors would be well placed to do this.

This approach would be further enhanced if funds set aside for saving are transferred to a separate account, protecting that portion of an individual’s income from being diverted for other purposes (see Section 5.6 below).

? Do you agree that the savings buffer amount should be pre-entered by pre-filling an income and expenditure statement where possible?

3.5 Voluntary Participation—But Requiring ‘Opt Out’

We propose that participation by consumers in setting aside a savings buffer would be **voluntary**. As noted above however, where possible income and expenditure statements would include a default figure for the savings buffer. Consumers would therefore need to opt out if they did not wish to set aside any savings or save a lower amount than the minimum (and the line item in the income and expenditure statement would be “zero” or a figure less than \$20 per month.)

Alternatively, it could be **mandatory** that at least some amount was included as a savings buffer in all income and expenditure statements, even if this figure was below the proposed minimum amount.

? Do you agree that participation by consumers in setting aside some savings should be voluntary? Alternatively, should there be a mandatory requirement in relation to debt repayment arrangements so that some amount is set aside for savings (even if below the minimum amount)?

3.6 A Separate Account to Hold Savings

Ideally, any savings should be held in a separate account to the consumer’s current account. This may require the consumer to find and open a separate account for those savings, and to manage any administrative or cost issues associated with doing so.

Financial institutions could play a key role here in assisting their customers to open up dedicated accounts with no fees, such as basic bank accounts (where appropriate). Consumers might also look to a financial counsellor for guidance and referrals towards appropriate products.

¹³ The Behavioural Insights Team, UK Cabinet Office (2014), EAST: *Four simple ways to apply behavioural insights*

There is also an opportunity for Centrelink to facilitate saving by their customers. This could be through the Centrepay system so that customers can allocate funds to savings programs.

- ? Where should savings be deposited?*
- ? Do you agree that creditors have a role in helping people in financial difficulty set up accounts and mechanisms to deposit savings?*
- ? What role could Centrelink play in assisting consumers set aside a savings buffer?*

3.7 Evaluation in 18 Months

If a savings buffer is introduced, we also propose that the measure be subject to evaluation within a reasonable timeframe, say 18 months, and that the results of the evaluation would be published. To undertake an evaluation of this nature, we would need the support and active involvement of financial institutions and also some consumers.

- ? Do you agree that this measure should be evaluated? If so, we would welcome support from financial institutions that may wish to be involved in doing this.*

Chapter 4. Broader application of a savings buffer

4.1 Extending the Savings Buffer to Initial Lending Decisions

The emphasis in this paper has been on consumers in financial difficulty who are negotiating repayment arrangements for existing debts. We have argued that there are a number of very good reasons as to why a savings buffer should be factored into these negotiations and explicitly included in standard income and expenditure statements.

Similar arguments about the importance of a savings buffer also apply when a creditor first makes loans. It makes sense for anyone taking on a financial commitment to allow for a savings buffer to cover unexpected expenditure in the future. The arguments outlined in Section 4 above apply—a savings buffer will be good for both consumers and creditors.

? *Do you agree that creditors should include a savings buffer in income and expenditure statements when consumers apply for a loan?*

4.2 Responsible Lending

Australia's credit laws require credit providers to lend responsibly. This means that a creditor must assess a consumer's capacity to repay a loan, as well as whether the proposed loan meets the consumer's requirements and objectives.

In our view, the inclusion of a savings buffer in assessing a consumer's capacity to repay a loan is a fundamental component of responsible lending. If this were the case, the failure of a creditor to consider whether a consumer had at least some capacity to save even a small amount could be a breach of responsible lending laws. (This is not to place any obligation on consumers to actually save, only that this should be part of the standard lending assessment.)

A further factor in this discussion is the widespread use by creditors of benchmarks to estimate general living expenses of potential borrowers.

? *Is there any intersection between the responsible lending obligations in the credit law and a savings buffer in assessing capacity to repay?*

? *Could the concept of a savings buffer be incorporated into lending assessment systems that use benchmarks for living expenses?*

Some interesting and relevant data

Financial Stress

- 31.8% of households in Australia are financially stressed (financial stress is defined as not being able to meet financial commitments as they fall due)

Source: Digital Finance Analytics and the Monash University Centre for Commercial Law and Regulatory Studies, *The stressed household finance landscape report 2015*, p7 <http://digitalfinanceanalytics.com/reports.html>

- 13% of the population would be unable to raise \$2,000 within a week for something important and 19% of the population had at least one cash flow problem in the last 12 months (such as being unable to pay an electricity, gas or telephone bill on time).

Source: Australian Bureau of Statistics, *4159.0 General Social Survey: Summary Results, Australia 2014* (released 29/6/2015)

Poverty

- 2.5 million people or 13.9% of the population live below the poverty line. Of this group, 630,000 are children.

Source: Australian Council of Social Service, *Poverty in Australia 2014* http://www.acoss.org.au/images/uploads/ACOSS_Poverty_in_Australia_2014.pdf

Financial Literacy

- Financial literacy is the ability to make informed judgements and to take effective decisions regarding the use and management of money. In 2015, the groups with lower financial literacy on average included: young people under 25 years of age, those with no formal post-secondary education, those employed in lower blue collar occupations and people with relatively low levels of income and assets.

Source: ANZ, *ANZ Survey of Adult Financial Literacy in Australia, May 2015*, <http://www.anz.com/resources/3/1/31cbc1fd-9491-4a22-91dc-4c803e4c34ab/adult-financial-literacy-survey-full-results.pdf>

Savings

- Three quarters of people said they try to save on a regular basis.

Source: ANZ, *ANZ Survey of Adult Financial Literacy in Australia, May 2015*, <http://www.anz.com/resources/3/1/31cbc1fd-9491-4a22-91dc-4c803e4c34ab/adult-financial-literacy-survey-full-results.pdf>

- 87% of participants in ANZ's Saver Plus, a matched savings program, continue to save the same amount or more after the program finishes. 61% save a set amount regularly.

Source: Roslyn Russell, Mark Stewart and Felicity Cull, RMIT University, *Saver Plus: A Decade of Impact*, <http://www.anz.com/resources/a/7/a7ab5ce8-9cf1-42f6-8a02-46dfe2fe5194/saver-plus-decade-impact.pdf?MOD=AJPERES>

Thank you for taking the time to read this paper.

Comments are sought by Friday 1st July 2016.

FCA will then summarise this feedback, adjust our approach as needed and issue a final report.



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